Research Department
Federal Reserve
Bank of
San Francisco

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FRBSF Weekly Letter

New World for CU's

In an era of volatile interest rates and uncertain economic activity, the nation's 22,000 credit unions provide an important source of credit and a convenient form of saving to many individuals who might be overlooked by other financial institutions. They trail only commercial banks and finance companies in the consumer-lending field, since loans to their 46 million members account for almost 15 percent of outstanding consumer credit. But credit-union growth recently has fallen behind the headlong pace of the early 1970's—and today, like other financial institutions, they must face the challenge of deregulation in a weakening economic environment.

Recent history

Credit-union shares (deposits) expanded at a 17-percent annual rate through most of the 1970's, but then increased at only half that rate between 1978 and 1980. Growth so far this year has been even slower, running at an annual rate of only 2 percent. The pre-1978 performance reflected the CU's ability to pay higher rates on their regular share accounts than commercial banks or savings-and-loan associations could pay on their passbook accounts. Most credit unions at that time paid over 6 percent interest, and many paid the 7-percent legal maximum.

The situation changed in 1978, however. On the liability side, credit unions faced growing competition from banks' and thrifts' money-market certificates and from the rapidly expanding money-market mutual funds. While credit unions received authorization to offer money-market share certificates in late 1978, many did not do so at that time because of the high cost of these instruments. On the asset side, the 12-percent ceiling on the Federal CU's loan rate, and various usury ceilings on state CU's loan rates, prevented the yield on their loan portfolios from rising in line with the general level of interest rates. Credit unions could not raise their rates to borrowers, and thus could not raise the dividends paid on members' shares—which of course limited their ability to attract new funds.

Removing rate ceilings

To resolve this conflict, the National Credit Union Administration—which controls the 12,500 Federal CU's with $36 billion in shares—recently increased the maximum rate Federal CU's can pay on regular share accounts to 12 percent, while liberalizing the rates on other types of accounts. (The 9,000 state-chartered CU's, with some $28 billion in shares, are largely governed by individual state regulations.) Also, the NCUA removed entirely the rate ceiling on individual retirement accounts. Some states meanwhile have changed the restrictions on the rates state CU's can pay on shares. All CU's can now offer All Savers Certificates.

On the lending side, the NCUA since December 1980 has allowed Federal credit unions to charge up to 21 percent on loans, at least on a temporary basis. (The permanent maximum is 15 percent under the Monetary Control Act.) Also, with the raising or elimination of usury ceilings, many state-chartered credit unions are now able to charge higher loan rates. In those states where usury ceilings are still binding, Federally-insured CU's under the MCA can now charge at least one percentage point more than the Federal Reserve Bank's discount rate.

Reflecting these rate changes, the average yield on credit-union loans has risen from 11.7 percent in July 1980 to 13.2 percent in July 1981. Moreover, CU earnings have quickly shown the results of higher rates because of the rapid turnover of their loan portfolios. Unlike savings-and-loan associations with their portfolios of fixed-rate, long-maturity loans, credit unions make loans with an average maturity of just over 30 months, and their loan portfolios turn over once in every 16 to 20 months. (Credit unions are

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probably thankful now that they failed to receive authorization for increased mortgage lending; otherwise, they might have found themselves in the same boat as the S&L's.) Despite the rising cost of funds, credit unions in 1980 managed to maintain a spread of nearly four percentage points between their average loan yield and their cost of funds—roughly in line with the spread maintained by small banks last year. In the future, however, such a spread will become more difficult to achieve.

Long-term challenges

In the longer term, credit unions face some major problems. They are now losing a long-held competitive advantage over other depository institutions, with the elimination of deposit-rate ceilings mandated by the Depository Institutions Deregulation and Monetary Control Act of 1980. Federal CU's have a temporary advantage in this process, because the decisions of the Depository Institutions Deregulation Committee do not apply to the NCUA, even though the NCUA chairman is a voting member of the DIDC. While the NCUA has deregulated rate ceilings rapidly, the DIDC has moved slowly because of concern over the thrifts' earnings predicament.

At the same time that rate ceilings are lifted, however, credit unions face the increasingly aggressive stance of financial institutions generally, as well as the growing financial sophistication of savers seeking higher returns on savings. To remain competitive, CU's will have to offer their members a broader range of share accounts at market rates. But this may be difficult for many smaller institutions—roughly half of all CU's hold less than $500,000 in share accounts. Credit unions thus have a choice between becoming full-service financial institutions or remaining providers of limited services to their memberships.

In this environment, the development of electronic technology may be both a blessing and a curse. With cheap computers and simple-to-use software packages, credit unions can now provide a broader range of services. But with recent technical advances, banks and S&L's can also offer payroll deductions and automatic-teller services. These developments reduce the advantage of convenience that many credit unions have had in providing services to their members. For some credit unions, the answer may lie in emphasizing the importance to members of the common bond that unites them. For others, these challenges may stimulate them to provide services matching those available from other financial institutions.

Some institutions have responded by switching to a community (residential) bond from an occupational or associational bond. (About 80 percent of CU's have occupational bonds, while only 4 percent have residential bonds.) This switch gives the credit union more diversity in its membership and a broader base of potential members—and thus makes it less susceptible to losses from the failure of a single employer. However, this switch also can weaken the common bond among a credit union's members. It also encourages other depository institutions to challenge the special status of credit unions, especially regarding their exemption from taxes. Thus, the liberalizing of financial institutions poses a real dilemma for credit unions.

Short-term problems

Meanwhile, credit unions are forced to deal with a difficult economic situation. How well placed are they to weather the present weakness in the economy? On average, they have adequate capital and sufficient liquidity to cope with loan losses and any unevenness in flows of funds. Admittedly, the capital-to-assets ratio of Federally-insured credit unions dropped from 8.0 percent in 1970 to 6.1 percent in 1980. (This compared with a decline from 7.0 percent to 5.3 percent for S&L's.) In part, this drop reflected the introduction of Federal share insurance, with the creation of the National Credit Union Share Insurance Fund in 1971. With Federal insurance, credit unions can afford to maintain smaller capital ratios, since they need less capital to protect their members from excessive loan losses.

In 1980, the NCUA placed 236 credit unions in involuntary liquidation because of insolvency—the largest number since 1971. But most of these (72 percent) had less than $100,000 in shares. The increase also reflected the impact of the new bankruptcy law, which increases CU loan losses through its provisions for protecting debtors' assets. Charge-offs (losses) due to borrower bankruptcy more than doubled in the first year under the new bankruptcy code (fiscal 1980). Because of this factor, as well as the current recession, CU bad-debt losses are likely to rise in the year ahead. Credit unions will have to review their procedures for analyzing borrowers' credit worthiness, to keep any increase to a minimum.

These loan losses, however, are less likely to cause a withdrawal of shares by members, with the higher ($100,000) ceiling on share insurance under the terms of the Monetary Control Act. Moreover, with the well-developed network of over 40 corporate-central credit unions, CU's now have greater ability to weather any sudden withdrawals of shares. The U.S. Central Credit Union serves as the "bank" for these corporate centrals, and they in turn serve as correspondent-banking facilities for individual institutions. In the future, U.S. Central plans to provide a package of services put together from the lowest-cost sources, including the Federal Reserve System.

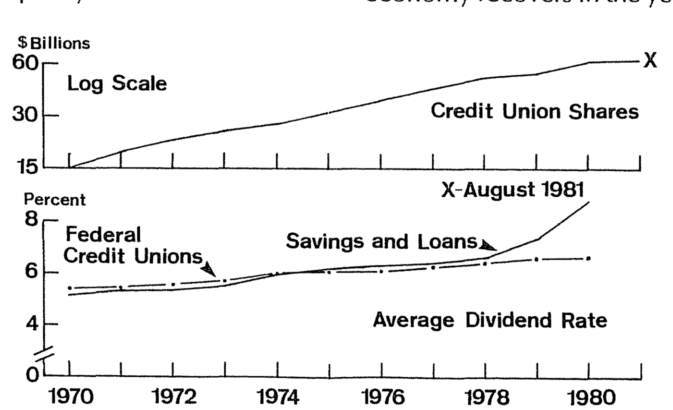
An additional source of liquidity is the NCUA's Central Liquidity Fund. The Fund already has helped some credit unions overcome liquidity problems, avoid capital losses, and provide continued service to members. Finally, under the MCA legislation, credit unions now have access to the Federal Reserve System as well. Although individual credit unions are unlikely to use Fed services directly, they should benefit from indirect use of such services.

General outlook

The state of the economy and the increased deregulation of depository institutions will pose many challenges to credit unions in the year ahead. The weakening economy will bring loan losses and other difficulties as bankruptcies and unemployment take their toll of both firms and individuals.

Although the present recession makes the transition to a deregulated environment more difficult, credit unions are better placed than many other financial institutions to take up the challenge. Regulatory authorities are lifting rate ceilings on share accounts and loans, and are liberalizing other restrictions on the nature and type of instruments credit unions can offer. Of course, this liberalization is not proceeding at the same pace everywhere; in some states, usury ceilings still apply. But CU's now have access to a broader range of services, especially from the corporate-central credit union system. While credit unions cannot hope to return to the rapid growth of the 1970's, on the whole their prospects for growth should improve as the economy recovers in the year ahead.

Roger Lister



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 11/4/81	Change from 10/28/81	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	153,471	161	9,644	6.7
Loans (gross, adjusted) — total#	132,626	160	10,943	9.0
Commercial and industrial	40,125	387	4,224	11.8
Real estate	55,010	31	5,587	11.3
Loans to individuals	23,252	44	– 672	– 2.8
Securities loans	1,837	415	665	56.7
U.S. Treasury securities*	5,575	– 31	– 1,136	– 16.9
Other securities*	15,270	32	– 159	– 1.0
Demand deposits — total#	41,336	2,524	– 7,213	– 14.9
Demand deposits — adjusted	28,140	236	– 6,460	– 18.7
Savings deposits — total	29,751	537	– 328	– 1.1
Time deposits — total#	85,065	– 511	18,787	28.3
Individuals, part. & corp.	77,176	– 447	19,843	34.6
(Large negotiable CD's)	32,545	– 564	6,994	27.4

Weekly Averages of Daily Figures	Week ended 11/4/81	Week ended 10/28/81	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (–)	N.A.	72	96
Borrowings	N.A.	13	167
Net free reserves (+)/Net borrowed(–)	N.A.	59	– 71

* Excludes trading account securities.
# Includes items not shown separately.

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